Introduction
There is currently a complex web of more than three thousand international investment agreements. Most contain ‘investor to state dispute settlement’ (ISDS) mechanisms that allow foreign investors unprecedented rights over democratic policy making – including the right to sue governments in private arbitration tribunals outside the regular national court system. Investors’ claims through ISDS have skyrocketed by more than 400% since the early 1990s.

This paper will demonstrate that there are a range of alternative mechanisms through which investments can be protected and which have a much less damaging effect on democratic public policy making and the rule of law than ISDS. Some of these alternatives are already being successfully implemented by governments around the world. Whilst each alternative clearly has room for improvement, we urge parliamentarians and policy makers to explore, improve and promote options which do not undermine the ability of countries to implement policies in the public interest.

The problems with ISDS
There are many problems with the ISDS system. Two of the most important are:

• ISDS lawsuits threaten democratic decision making. Investors are able to challenge public policy measures in private arbitration tribunals that lack public oversight and do not adhere to basic rule of law principles.
• The costs of defending a case can run into millions and compensation awards often into millions, sometimes billions, putting pressure on public budgets.

Investment agreements don’t help countries attract investment
An UNCTAD study of 133 countries found that the impact of bilateral investment treaties (BITs) on foreign direct investment (FDI) is non-existent or small, and secondary to the effects of other determinants.

The evidence speaks for itself. Japan, the second largest source of FDI in the world, has only 4 BITs. The US does not hold a BIT with China, despite the latter being the largest developing country destination for US FDI. Brazil, receives substantial FDI, but does not hold any ratified BITs. In contrast numerous countries that have ratified BITs still have real difficulties attracting FDI, particularly in Sub-Saharan Africa.

Reform is not the answer
There is currently a heated public debate within the EU about the need to reform ISDS, particularly in the context of the ongoing TTIP negotiations with the United States and CETA deal with Canada. Meanwhile countries around the world are making radical changes to their investment agreements or indeed moving away from that model of investment protection altogether. Despite the clear threat of ISDS to democracy, courts and public budgets, the European Commission is continuing to propose weak and inadequate reforms to ISDS. Its latest proposal for an International Investment Court tackles some of the challenges regarding the secrecy and bias of the current ISDS system, but fails to address the substantive issue of investors challenging government decisions outside of domestic legal processes.

ISDS is not necessary to protect investments
The continued insistence on ISDS is particularly surprising given that the combination of domestic courts, investment contracts, state-to-state arbitration and political risk insurance already provide robust protection for foreign investment without the need for ISDS. The following sections will set out the different existing options investors can use to ensure that their investments are protected, without compromising public policy decisions.

Option 1: Domestic courts
Investors can use the domestic legal system of the host state as the means through which disputes with the host government are resolved. This form of dispute resolution may be specified in an investment instrument (such as a contract or treaty) or can also be the default dispute resolution forum where a treaty or contract does not exist. Brazil and South Africa both attract significant foreign direct investment and primarily use this form of dispute resolution. Domestic legal systems are readily available to foreign investors and offer similar protections to those covered by ISDS for example for expropriation, civil unrest and taxation.

There are a number of reasons why using the domestic legal system will offer a claimant investor and a respondent government fairer access to justice:

• Domestic legal systems are designed to balance both private and public interests, and will cover a wide range of issues beyond investment protection, such as human and environmental rights.
• Under the principle of the rule of law, domestic laws are to be applied consistently and predictably by the courts.
• Decisions made in the court of first instance are subject to correction in the upper courts. Should an erroneous decision be made in the lower courts, both parties to the dispute will have the opportunity to appeal to a higher domestic court. This puts both the government and the investor on similar legal footing. Decisions made on this basis are likely to be seen as more legitimate by the host country population.
• Parties to a dispute in domestic courts may spend less money fighting a case than if they had to constitute an investment tribunal, particularly in minor disputes.

**Option 2: Political risk insurance**

In countries where corruption is a potential issue or where investors may have concerns regarding the impartiality of domestic courts, political risk insurance is a possible alternative. Political risk insurance can be purchased by foreign investors who wish to underwrite any costs that may be incurred as a result of political changes within the host state. There are three types, government sponsored, insurance backed by the Multilateral Investment Guarantee Agency (MIGA) which is a member of the World Bank group and private insurance. Most insurers will cover investments regardless of whether an investment agreement or ISDS provision is in place. In some cases the risks covered by political risk insurance can exceed the protections offered by ISDS in a BIT.

The main disadvantage of political risk insurance is the cost. Private political risk insurance tends to be more expensive than that issued by governments. However there is a clearly a question as to whether tax payers should bear the cost of insuring business risk.

Political risk insurance is an obvious market-based solution for investors working in risky and high-return environments.

**Box 2**

**Cost of arbitration to tax payer**

- Number of claims above US$ 1 billion: 65 known cases
- Average amount awarded to investors: US$ 575 million
- Highest amount claimed in 2014: US$ 2.5bn
- Highest amount awarded in 2014: US$ 50bn

**Source:** UNCTAD 2015

**Option 3: Investment contracts**

Investment contracts are bespoke agreements negotiated and concluded between a private investor and a host state to protect the investment associated with a particular project. Protections are time limited and there is great flexibility in the design of the dispute resolution clause. The main advantage of investment contracts is that the host state can decide what protections it is willing to offer to a particular private investor on a project by project basis. The list of claimants is clear and closed. There is no opportunity for the investor to ‘treaty shop’ based on the provisions available in a concluded BIT or investment agreement. Host states can tweak the design of each contract depending on their experience. In an ideal situation, the host state would be able to alter the terms without going through the public procurement process again.

However in practice there are significant problems with investment contracts. Many are concluded in secrecy. This is the case, even for some countries in which the national law requires parliamentary vetting of contracts. In cases where secrecy surrounds the negotiation of an investment contract, the possibility exists for the state to sign up to terms that conflict with public policy priorities. There is also often a clear imbalance of power between the investor and the host state negotiating, which may lead to states agreeing to grant investors excessive rights and privileges. Within an investment contract the parties can opt for any of the other dispute resolution methods discussed in this paper.

**Box 3**

**Who is winning investment cases?**

According to UNCTAD 2015 figures, sixty percent of cases were found in favour of the investor or the Government settled. In the other forty percent the state has successfully defended against an allegation, but may still have incurred considerable costs.
Option 4: State-to-state arbitration
This form of investment related dispute resolution was a defining feature of the very first bilateral treaties. It is where two states resolve a dispute on behalf of the investor through the procedure of binding arbitration. It is normally specified in a BIT or a regional investment agreement. As part of this procedure, the home state will usually represent the concerns of the investor to the host state. It can help resolve disputes quickly because the nature of relationships between states tends to be one of cooperation rather than confrontation. States are more likely to follow the well-established rules of customary international law i.e. the exhaustion of local remedies such as domestic courts before attempting arbitration. One country that has been innovative in its use of state-to-state arbitration to resolve disputes is Brazil.

However, this form of dispute resolution has similar pitfalls to ISDS depending on which rules are specified – particularly regarding lack of transparency. Contracting parties would need to ensure that rules such as UNCITRAL transparency rules are in place for state-to-state arbitration to be more open. Secondly, due to the cooperative nature of states’ interaction, they may be reluctant to represent a private investor on a dispute that represents a small claim and may choose to be receptive only to politically symbolic and economically important disputes. ISDS however is similarly difficult for small firms to access because of the cost of arbitration.

Box 4

Country reform trends

**Bolivia** withdrew from ICSID, the World Bank body that administers ISDS in 2007. It changed its constitution to require foreign investors to resolve disputes in domestic courts. By 2013, Bolivia had denounced all of its BITs which contained ISDS provisions. The country then launched a task force to review its investment regime which resulted in a new investment law and model BIT. These require foreign investors to comply with local laws that protect social, economic and tax priorities and protect the country’s biodiversity. The new policy has not deterred foreign investors; investment inflows to the country increased steadily and peaked in 2013.

**Brazil**: None of the BITs that Brazil signed in the 1990s were ratified. In 2015, due to its growing outward investment Brazil signed three co-operation and investment agreements which are designed to promote and protect investments, as well as limit challenges to new socio-economic, health and environmental laws. Disputes are to be resolved through a bilateral joint committee should other measures such as a special ombudsman service to assist investors and redress in domestic courts not be successful. ISDS is prohibited.

**Ecuador**: In 2008, the constitutional court of Ecuador declared all BITs which contained ISDS provisions unconstitutional. In 2013, Ecuador established an audit commission to review its investment treaty regime. To date, the tribunal has recommended the termination of all existing BITs after finding irregularities in the BIT ratification process; evidence of arbitrator conflict of interest and no linkage between FDI inflows and the signing of BITs.

**India**: The government of India decided to suspend the signing of new BITs, which contained ISDS clauses and to review its model BIT in 2012 after facing many high value investment treaty claims. The new model BIT completely excludes the most onerous investor protection clauses, restricts others and preserves policy space for India to regulate in areas such as the environment, public health and safety. It requires investors to exhaust remedies available through local Indian courts or administrative bodies before pursuing an ISDS claim.

**Indonesia**: The Indonesian government has recently reviewed its investment regime as a result of an increased exposure to investment arbitration claims. The review body removes automatic recourse to ISDS by requiring the host state and the investor to consent to arbitration after a dispute has arisen, on a case by case basis.

**South Africa**: South Africa reviewed its investment policy framework between 2008 and 2011. The review revealed no economic benefits had been derived from the signing of BITs which contained ISDS provisions. It recommended terminating existing BITs. Since then, South Africa has developed a new investment law, which is currently with Parliament for ratification. It offers similar investment protections to previous BITs, but in a manner consistent with constitutional priorities such as redressing social inequalities and protecting the environment. It removes any recourse to ISDS, requiring the resolution of disputes via the South African legal system.
Conclusion
On balance, the benefit of signing up to BITs or other investment agreements containing ISDS provisions is contested and the costs to sovereignty and public budgets can be very high. Domestic laws and courts can offer a reliable, independent and fair alternative means of settling disputes. Investment contracts are a way for governments to protect a particular investment project, but need much greater transparency. State-to-state arbitration offers states a way of promoting their investment and diplomatic agendas and preventing frivolous claims by investors. Investors can also opt for several political risk insurance options when investing overseas. With these four types of protections available there seems little need for the undemocratic and secretive process that is ISDS in the investment law regime.

Recommendations
Given that foreign investment can be well protected outside ISDS, we therefore call on the European Commission and European Members states:

- To drop ISDS from all Free Trade and Bilateral Investment Agreements.
- To explore, promote and improve alternatives to ISDS which have less impact on countries’ regulatory autonomy.

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